

IT 06-9

Tax Type: Income Tax

Issue: Net Operating Loss Carryback

**STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS**

**THE DEPARTMENT OF REVENUE
OF THE STATE OF ILLINOIS**

v.

**ABC SERVICES, INC.,
Taxpayer**

**No. 05-IT-0000
FEIN: 0000000000
FYE 3/31/94**

**Ted Sherrod
Administrative Law Judge**

RECOMMENDATION FOR DISPOSITION

Appearances: Special Assistant Attorney General Sean P. Cullinan on behalf of the Illinois Department of Revenue; Thomas J. Dwyer of Thomas J. Dwyer & Associates on behalf of ABC Services, Inc.

Synopsis:

This matter is before the Department of Revenue (hereinafter referred to as the “Department”) Office of Administrative Hearings as the result of a timely protest by ABC Services, Inc. (hereinafter referred to as “taxpayer”) of the Illinois Department of Revenue’s denial of taxpayer’s claim for refund for the fiscal year ended 3/31/94. On October 9, 1997, the taxpayer filed a timely income tax return for FYE 3/31/97 carrying forward a FYE 3/31/96 net operating loss (“NOL”) to offset its entire income for FYE 3/31/97. The Internal Revenue Service subsequently audited the taxpayer’s federal income tax return for 1994 in 2003, and determined an additional amount due. The taxpayer reported the IRS federal change on an IL-1120-X for 1994, but attempted to

offset the entire liability shown to be due as a result of the federal change by carrying back the portion of the 1996 NOL not previously applied to offset its 1997 income to 1994, which resulted in an overpayment for that year. The Department's auditor audited the taxpayer's amended return for 1994 and denied the NOL carryback to 1994 claimed by the taxpayer on the grounds that the taxpayer's carryforward to 1997 constituted an "irrevocable election" to forego any net operating loss carryback pursuant to section 207 of the Illinois Income Tax Act, 35 ILCS 5/207. The taxpayer timely protested the Department's denial of its refund claim for 1994 resulting from the Department's refusal to allow an NOL carryback to 1994, and also objected to the doubling of interest and penalties on the unpaid liability for 1994 resulting from the denial of this NOL carryback imposed pursuant to 35 ILCS 735/3-2(f) and 35 ILCS 735/3-3(i). A hearing was held on this matter on January 9, 2006, with John Doe, CPA, testifying for the taxpayer. An extensive stipulation of facts was also entered into the record during these proceedings along with other documentary evidence and briefs. Following the submission of all evidence and a review of the record in this case, it is recommended that the denial of the taxpayer's refund claim, including the auditor's doubling of interest and penalty resulting from the taxpayer's failure to timely pay the amount due on its 1994 amended return reporting federal changes, be finalized as issued. In support thereof, I make the following findings of fact and conclusions of law.

Findings of Fact:

1. ABC Services, Inc. ("taxpayer"), an Illinois corporation, having its principal place of business in Anywhere, Illinois, is engaged in the business of providing street

cleaning and highway cleaning services in this state. Taxpayer Exhibit 2 (“Ex.”) D-1, D-2.

2. On December 11, 1996, the taxpayer timely filed its Illinois corporate income tax return for the fiscal year ended March 31, 1996 and reported a net operating loss of \$255,712. Taxpayer Ex. 1, Stipulation of Facts (hereinafter “Stip.”) No. 1; Taxpayer Ex. D-2.
3. The taxpayer’s federal and Illinois corporate income tax returns for fiscal years ending prior to 1996, and for the fiscal year ended March 31, 1996, were prepared by Mr. Jones, a certified public accountant. Tr. pp. 20, 31, 32; Stip. No. 2; Taxpayer Ex. A-1, A-2, B-1, B-2, C-1, C-2, D-1, D-2.
4. Neither the taxpayer’s federal corporate income tax return nor the taxpayer’s Illinois corporate income tax return for the fiscal year ended March 31, 1996, both of which were filed in December, 1996, included any statement attached to the return for the taxable year indicating the section providing for an election to forego an NOL carryback, information identifying the election, the period to which the election applies, and the taxpayer’s basis for entitlement to the election, as required to elect to forego an NOL carryback for federal income tax purposes by Sec. 301.9100-12T (d), Temporary Proced. & Admin. Regs., 57 Fed. Reg. 43896 (Sept. 23, 1992). Tr. p. 32; Taxpayer Ex. D-1, D-2.
5. No amended Illinois corporate income tax returns were filed for the fiscal years ended March 31, 1993, 1994 or 1995 to carryback the taxpayer’s 1996 Illinois net operating loss at the time the taxpayer’s federal and Illinois corporate income tax returns for fiscal year ended March 31, 1996 were filed. Stip. No. 3.

6. On October 9, 1997, the taxpayer timely filed its Illinois corporate income tax return for the fiscal year ended March 31, 1997. This return was prepared and filed by Smith & Jones Accounting Service rather than by Mr. Jones, the preparer of the taxpayer's returns for fiscal years ended prior to the fiscal year ended March 31, 1997. Tr. pp. 20, 31, 32; Stip. No. 4; Taxpayer Ex. E-1, E-2.
7. The taxpayer's fiscal year ended March 31, 1997 Illinois corporate income tax return included a schedule NLD which indicated a 1996 Illinois net operating loss carryforward in the amount of \$255,712, of which \$55,823 was utilized to offset the net income for the fiscal year ended March 31, 1997. The taxpayer had income of \$65,476 in the fiscal year ended March 31, 1994 and \$117,339 in the fiscal year ended March 31, 1995. However it did not carry losses back to either of these years on its Illinois corporate income tax returns as originally filed for 1996 and 1997. Stip. No. 5.
8. The Internal Revenue Service ("IRS") audited the taxpayer's corporate income tax returns for fiscal years ended March 31, 1993, March 31, 1994, March 31, 1995 and March 31, 1996. Adjustments to taxable income for the fiscal year ended March 31, 1994 were proposed and accepted by the taxpayer on April 3, 2003. Stip. No. 6.
9. The amount determined to be due Illinois as a result of the federal changes to the taxpayer's 1994 federal return that were proposed by the IRS and accepted by the taxpayer, before applying the net operating loss from 1996 to the taxpayer's 1994 return, was \$13,771. Department Exhibit ("Ex.") 4. Since the taxpayer failed to pay this amount and the Department's auditor denied the taxpayer a net operating

loss carryback from 1996, the taxpayer's return showed an unsatisfied liability in this amount, and the Department's auditor assessed interest and a penalty for failure to timely pay taxes due and owing. Taxpayer Ex. I-1. Since the liability that was not satisfied was eligible for tax amnesty if satisfied during the tax amnesty period prescribed pursuant to P.A. 93-26, effective 6/20/2003, which extended from October 1, 2003 through November 17, 2003, the interest and penalty assessed were doubled in accordance with 35 **ILCS** 735/3-2(f) and 35 **ILCS** 735/3-3(i). *Id.*

10. On or before November 14, 2003, the taxpayer filed an amended Illinois corporate income tax return for the fiscal year ended March 31, 1994. The fiscal year ended 1994 amended return was filed during the Illinois tax amnesty period. The fiscal year ended March 31, 1994 amended return requested a refund of \$1,405 as a result of the utilization of the portion of the 1996 net operating loss not previously carried forward to fiscal year ended March 31, 1997. Stip. No. 7.
11. On February 9, 2005, the Department issued a Notice of Denial, pertaining to the Illinois amended corporate income tax return for the fiscal year ended March 31, 1994, indicating that no portion of the taxpayer's net operating loss for fiscal year ended March 31, 1996 could be carried back to the two years preceding fiscal year ended March 31, 1996 as claimed by the taxpayer, because the net operating loss had previously been carried forward to fiscal year ended March 31, 1997 on the taxpayer's timely filed Illinois corporate income tax return for that year. Stip. No. 8.

Conclusions of Law:

The issues to be decided in this case, as stated in the pre-trial order dated September 29, 2005, are as follows:

1. ...[T]he first issue to be decided in this matter is whether ABC Services, Inc. properly carried back NOLs incurred in fiscal year ending (“FYE”) 3/31/96 to FYE 3/31/94 due to an increase in Illinois tax liability resulting from a federal change when taxpayer had already carried forward portions of the NOLs incurred in FYE 3/31/96 to 3/31/97;
2. That the second issue is whether the filing of the FYE amended return for 1994 within the amnesty period qualified the taxpayer to avoid the application of penalty and interest in the event of a negative finding against the taxpayer in issue number one above
...

With respect to the first issue, the Illinois Income Tax Act (“IITA”) provides that, when an Illinois taxpayer’s net income for any taxable year ending prior to December 31, 1999 results in a loss, “such loss shall be allowed as a carryover or carryback deduction in the manner allowed under Section 172 of the Internal Revenue Code.” 35 ILCS 5/207(a)(1). Section 172 of the Internal Revenue Code, as in effect for the tax year 1996, allows a net operating loss to be carried back to each of the three taxable years preceding the taxable year of the loss and forward to each of the 15 years succeeding the year of the loss. Internal Revenue Code (“IRC”) section 172(b)(1)(A)(i),(ii), 26 U.S.C.A. section 172(b)(1)(A)(i),(ii), as in effect before amendment by sec. 1082(a)(1), PL 105-34, 8/5/97. The manner in which losses must be carried back and carried forward is set forth in Internal Revenue Code section 172(b)(1)(A), and (b)(2) which provide as follows:

- (b)(1) Years to which loss may be carried.
 - (A) General rule. Except as otherwise provided in this paragraph, a net operating loss for any taxable year-
 - (i) shall be a net operating loss carryback to each of the 3 taxable years preceding the taxable year of the such loss, and

(ii) shall be a net operating loss carryover to each of the 15 taxable years following the taxable year of the loss. ...
... (2) Amount of carrybacks and carryovers. The entire amount of the net operating loss for any taxable year ... shall be carried to the earliest of the taxable years to which (by reason of paragraph (1)) such loss may be carried. The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried.
26 U.S.C.A. sec. 172(b)(1)(A), (b)(2)

Pursuant to these provisions, a net operating loss must be carried back to the earliest of the three years preceding the year of the loss in which the taxpayer has net income before being applied to any subsequent years. Moreover, only after a loss has been applied as a carryback to each of the years preceding the year of the loss in which there is income can any remaining portion of the loss be used as a net operating loss carryforward.

Both the Illinois Income Tax Act, as in effect for the tax years in controversy, and the Internal Revenue Code allow an exception to the mandatory procedures outlined above whereby a taxpayer can apply an NOL to years subsequent to the year in which the NOL arose without first carrying the loss back to the each of the three preceding years in which it has income. Specifically, a taxpayer may elect to relinquish its entire carryback and carryforward the entire net operating loss. In Illinois, 35 **ILCS** 5/207(a)(2)(A) provides as follows:

(A) The taxpayer may elect to relinquish the entire carryback period with respect to such loss. Such election shall be made in the form and manner prescribed by the Department and shall be made by the due date (including extensions of time) for filing the

taxpayer's return for the taxable year in which such loss is incurred, and such election, once made, shall be irrevocable.¹

See also 26 U.S.C.A. section 172(b)(3).

Both the Illinois Income Tax Act and the Internal Revenue Code provide that an election to forego an NOL carryback, which allows a taxpayer to carryforward an NOL without first applying it to offset income in the 3 years preceding the year of the loss, is irrevocable. *Id.* Moreover, as indicated by the language from 35 **ILCS** 5/207(a)(2)(A) noted above, an election to forego a net operating loss carryback must be made before the extended due date of the taxpayer's IL-1120 for the year of the loss. In sum, if a taxpayer does not make an election to forego an NOL carryback, it must apply the NOL first to the earliest of 3 years preceding the year of the loss in which it has net income that can be offset by the NOL. Further, only after an NOL has been applied to offset income for each of the 3 years preceding the year of the loss, can any remaining portion of the loss be carried forward. Conversely, if an election to forego an NOL carryback is made, a taxpayer may carryforward its loss for up to 15 years succeeding the year of the loss without carrying any portion of it back to the 3 years preceding the year of the loss. However, this type of carryforward can be made only if an election to forego an NOL carryback has first been properly made.

Taxpayer's IL-1120 for FYE 3/31/94 was originally filed on September 15, 1994.

On December 11, 1996, taxpayer filed an IL-1120 for FYE 3/31/96 showing a net loss of

¹ See also Illinois regulation 86 Ill. Admin. Code, ch. I, section 100.2330 which provides, in part, as follows: "Any taxpayer entitled to a net loss carryback may elect to relinquish the entire carryback period with respect to a net loss for any taxable year ending on or after December 31, 1986. Such election, once made for any taxable year, shall be irrevocable for that taxable year." 86 Ill. Admin. Code, ch. I, section 100.2330(c)

\$255,712. On October 9, 1997, taxpayer filed an IL-1120 for the tax year ending 3/31/97. Taxpayer Ex. 2. On this IL-1120, taxpayer showed net income of \$55,823, which was offset by an Illinois net loss deduction of \$55,823. *Id.* The taxpayer attached a “Schedule NLD Illinois Net Loss Deduction” to its IL-1120 for FYE 3/31/97. *Id.* Part I, line 2a of this schedule calls for the “amount of Illinois net loss previously carried back or forward.” *Id.* Taxpayer made no entry on this line, indicating that no amount was previously carried back or forward. *Id.*

Taxpayer’s Federal income tax return for 1994 was the subject of a federal income tax audit that was finalized in April 2003. Tr. p. 8. As a consequence of this audit, taxpayer’s federal taxable income for 1994 was increased from \$60,847 to \$252,664. Department Ex. 4. The taxpayer reported this federal change on an IL-1120-X amended return for 1994 filed on or before November 14, 2003. Stip. No. 7.² On this amended return, the taxpayer offset the entire state income tax liability resulting from the increase in its federal taxable income as a result of the federal audit by carrying back to 1994 the portion of its 1996 net operating loss not previously used to offset its 1997 net income. *Id.* The amount of this NOL exceeded taxpayer’s net income for 1994, and the taxpayer sought a refund for 1994 in the amount of \$1,405. *Id.*

The taxpayer attached a “Schedule NLD Illinois Net Loss Deduction” to its IL-1120-X amended return for 1994. Department Ex. 4. On Part I, line 2a of this schedule, which calls for the “carry year and the amount of Illinois net loss previously carried back

² P.A. 93-26, effective 6/20/2003, the “Tax Delinquency Amnesty Act”, creates an amnesty program for payment of any taxes due to the state and collected by the Department of Revenue. The program provides for the abatement of penalties and interest on payment of taxes due for any period ending after June 30, 1983 and before July 1, 2002 if paid during an amnesty period from October 1, 2003 through November 17, 2003.

or forward” the taxpayer provided: “(carry year) 3/1993 (Loss carried) \$44,340.” This entry was incorrect because, on the taxpayer’s form IL-1120 for FYE 3/31/93 dated July 8, 1993, on Part IV, line 2 captioned “Illinois net loss deduction (NLD)”, the taxpayer showed no amount. Taxpayer Ex. A-2. Since the taxpayer did not report any net operating loss carryback on its return for FYE 3/31/93, the Department’s auditor, on the copy of the taxpayer’s return used with its workpapers, penciled in an amount on the taxpayer’s Schedule NLD to show as an “amount of Illinois net loss previously carried back or forward” the taxpayer’s carryforward of NOL to FYE 3/31/97 on its timely filed IL-1120 for that year. Tr. pp. 13, 14; Department Ex. 4.

Taxpayer argues that, although it carried forward its FYE 3/31/96 NOL to FYE 3/31/97 on its 1997 return, and applied it to offset its entire net income for that year, it never properly elected to relinquish the right to carryback its NOL for FYE 3/31/96 to FYE 3/31/94 and FYE 3/31/95. Taxpayer Brief headed “Stipulation of Facts” (hereinafter “Taxpayer Brief”) pp. 4–8. Consequently, the taxpayer contends, the Department should give effect to its carryback of a portion of the 1996 NOL to 1994 as shown on the taxpayer’s amended return form IL-1120-X for that year. *Id.*

The Department contests this claim, arguing that the taxpayer’s carryforward of its FYE 3/31/96 loss to FYE 3/31/97 constituted an “implicit election” to permanently relinquish any carryback of this loss pursuant to 35 ILCS 5/207(a)(2)(A). Department Reply Brief, pp. 2-7. In support of its position, the Department cites a number of private letter rulings. *Id.* The most pertinent of these is Private Letter Ruling 97-0098-GIL which expressly construes section 207 of the IITA to provide for an implicit election resulting from the carryforward of a net operating loss on a return for a year subsequent to the loss

year before any portion of the loss for that year has been carried back. With respect to such an implicit election, this private letter ruling states as follows:

...[A] taxpayer could implicitly make the election to forego the carryback period by filing a return carrying the loss forward before filing a return carrying the loss back. The implicit election arises because once the loss has been applied to any given year, the remaining portion of such loss may only be carried forward to the next taxable year in which the taxpayer has net income. See 86 Ill. Admin. Code Section 100.2330(c)

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Unlike Department regulations, which have the force and effect of law (see Craftmasters, Inc. v. Department of Revenue, 269 Ill. App. 3d 934, 940-41 (1995)), private letter rulings are not intended to be binding legal authority. Union Electric Co. v. Department of Revenue, 136 Ill. 2d 385, 400 (1990) (“[N]ormally private letter rulings have no precedential effect.”). Moreover, while an agency’s interpretation of a statute it administers (i.e., section 207 of the IITA), is entitled to deference, if the interpretation is erroneous it cannot be entertained. Flex v. Illinois Department of Labor Board of Review, 125 Ill. App. 3d 1021, 1024 (1st Dist. 1989). Consequently, in determining the applicability of Private Letter Ruling 97-0098-GIL, it must be determined whether there is any legal basis for the position the Department has taken therein.

Private Letter Ruling 97-0098-GIL cites as the legal basis for its finding of an “implicit election,” section 207 of the IITA which, with respect to the manner in which the election to forego a net operating loss carryback is to be made, states: “[S]uch election shall be made in the form and manner prescribed by the Department and shall be made by the due date (including extensions of time) for filing the taxpayer’s return for the taxable year in which such loss is incurred ... [.]” 35 ILCS 5/207(a)(2)(A). This private letter ruling also cites as authority provisions of 86 Ill. Admin. Code, ch. I, sec.

100.2330(c) stating that if an election is made “the loss may be carried forward and deducted only in years subsequent to the taxable year in which the loss was incurred.” While instructive, this statutory and regulatory language fails to enumerate any procedure for making an election to forego an NOL carryback. Rather, these provisions only address the timing of an election, and the manner in which an NOL is to be applied once a proper election has been made. Consequently, neither section 207 of the IITA, nor provisions of 86 Ill. Admin. Code, ch. I, sec. 100.2230 cited in Private Letter Ruling 97-0098-GIL support the position taken by the Department in this private letter ruling.

With respect to the procedures to be employed in electing to forego a net operating loss carryback, the Illinois income tax return instructions for the form IL-1120 for 1996 were revised in 1996 to provide as follows:

The Illinois net loss must be carried back 3 years, then forward 15 years unless you make the election to forgo the Illinois NLD carryback period by checking the box below Part IV, Line 1. This election must be made by the extended due date for the loss year return. Once made, the election is irrevocable. (emphasis added)

These instructions to form IL-1120, which were first incorporated into the tax return instructions in 1996,³ make it clear that the only proper procedure for electing to forego an NOL carryback is to check the box contained in Part IV, Line 1 of the IL-1120, thereby affirmatively indicating the taxpayer’s intent to forego the NOL carryback. The instructions that outline the mandatory procedure to be followed have the force and effect of Department regulations pursuant to 35 ILCS 5/1401 and 35 ILCS 5/1501(a)(19). The plain language of the instructions to the form IL-1120 mandate that the procedure the instructions outline be followed if an effective election to forego a net operating loss

³ The instructions to the IL-1120 form for 1996 state: “What’s New for 1996 ... A new box has been added to the form for the purpose of electing to forgo the Illinois net loss deduction carryback period.”

carryback is to be made. Consequently, the instructions to form IL-1120 adopted in 1996 expressly preclude any “implicit election” not undertaken in accordance with these instructions. Accordingly, for periods covered by the change in income tax return instructions indicated in the 1996 return form, there is no legal basis for any “implicit election” to forego the carryback of a net operating loss undertaken without following the requirements outlined in the return instructions.

However, the record in this case indicates that the taxpayer’s 1996 return was not governed by the instructions contained in the Department’s form IL-1120 as revised in 1996. The caption to the form IL-1120 for that year plainly indicates that this form is only applicable to taxpayers with fiscal years beginning in 1996. See caption at top of form IL-1120 for 1996, which states: “1996 Tax Return or fiscal year beginning _____, 1996 [.]” The taxpayer, in the instant case, did not file its return on a calendar year basis, and its fiscal year for 1996 commenced on April 1, 1995 rather than during 1996. Accordingly, the instructions to the 1996 return which, for the first time, mandated the procedure to be followed when making an irrevocable election to forego a net operating loss carryback, did not apply to the taxpayer for the period in which the loss was generated, which was the taxpayer’s fiscal year beginning April 1, 1995 and ending March 31, 1996. Given this fact, the issue presented in this case is whether there is any legal basis for the Department’s construction of section 207 of the IITA to provide for an “implicit election” to forego a net operating loss carryback for fiscal years beginning prior to 1/1/96.

As noted above, section 207 of the IITA does not address procedures to be utilized in effecting an election to forego a net operating loss carryback, and the Illinois

Income Tax Act contains no other provisions that address this question. Moreover, as also noted above, the instructions to form IL-1120 only address this issue for tax periods beginning in or after 1996. Accordingly, I find no Illinois statutory or regulatory authority on this issue for the tax period in which the taxpayer's NOL arose.

However, while the Illinois law contains no such authority on procedures to be used to forego an NOL carryback, this issue has been addressed on numerous occasions by the federal judiciary. Such authority is instructive in construing section 207 of the IITA since 35 **ILCS** 5/102 provides as follows:

Construction. Except as otherwise expressly provided or clearly appearing from the context, any term used in this Act shall have the same meaning as when used in a comparable context in the United States Internal Revenue Code of 1954 or any successor laws or laws relating to federal income taxes and other provisions of the statutes of the United States relating to federal income taxes as such Code, laws and statutes are in effect for the taxable year.

35 **ILCS** 5/102

Section 102 is a rule of statutory construction designed to provide uniformity between the Illinois Income Tax Act and the Internal Revenue Code where the same term is used in both statutes. See Rockwood Holding Co. v. Department of Revenue, 312 Ill. App. 3d 1120 (1st Dist. 2000); Bodine Electric v. Allphin, 70 Ill. App. 3d 844 (1st Dist. 1979). Since an “irrevocable” election is provided for in both section 207 of the IITA and in section 172 of the IRC, federal case law construing the effectuation of an “irrevocable” election under the IRC is clearly relevant in determining what constitutes an “irrevocable” election under section 207 of the IITA because, absent language to the contrary, this term has the same meaning when used in the IITA as it does when used in a comparable context in the IRC. This is particularly true with respect to procedures to elect to forego an NOL carryback since the methodology for computing and applying the

Illinois net operating loss for the tax year at issue incorporates by reference the procedures used in computing and applying net operating losses under IRC section 172. See 35 **ILCS** 5/207(a)(1) (“for any taxable year ending prior to December 31, 1999, such loss shall be allowed as a carryover or carryback deduction in the manner allowed under Section 172 of the Internal Revenue Code”). Accordingly, federal case law interpreting the concept of an “irrevocable” election provides conclusive guidance in construing the meaning of this concept when used in section 207 of the IITA in accordance with the rules of statutory construction indicated in 35 **ILCS** 5/102, and the incorporation by reference of procedures under section 172 of the IRC pursuant to 35 **ILCS** 5/207(a)(1).

Case law construing section 172 of the IRC has consistently and repeatedly rejected the concept of an “implicit election” based solely upon whether a loss carryforward is indicated on an income tax return. The leading case on this issue is Young v. Commissioner, 783 F. 2d 1201 (5th Cir. 1986) in which the court rejected the taxpayer’s claim that a taxpayer’s entry on a form submitted for the loss year indicating a carryforward of the entire loss to a subsequent year constituted an irrevocable election to forego a loss carryback. See also Mitchell Menaged, TC Memo 1991-79; John J. Garland, TC Memo 1993-190; Bobby E. Welch, TC Memo 1998-121; Vivendra R.K. Tewari, TC Memo 1986-194; Thomas J. Rosser v. Commissioner, TC Memo 2001-79; James F. McGuirl, TC Memo 1999-21. These authorities all hold that the mere indication of a carryforward on a return, without more, is too equivocal a manifestation of the taxpayer’s intent to constitute an irrevocable election to forego an NOL carryback under IRC section 172. The federal courts have consistently required a more definitive and unambiguous indication of the taxpayer’s intent than is provided by a mere return

entry, before any such election can be recognized. For the reasons noted above, pertaining to rules of statutory construction prescribed by 35 ILCS 5/102 applicable in this case, the procedures for making an “irrevocable” election pursuant to section 207 of the IITA should be construed in a manner consistent with the aforementioned case law interpreting the same “irrevocable” election under IRC section 172.

It should also be noted that a construction of section 207 of the IITA to bar an “implicit election” to carryforward an NOL based solely upon the manner in which an NOL is carried forward on the taxpayer’s subsequent return best comports with the clear intent of section 207 to require that an election to forego an NOL carryforward be made on or before the due date, including extensions, for filing a return for the year in which the NOL is incurred. See 35 ILCS 5/207(a)(2)(A). As cogently noted by the taxpayer in its brief, were the Department to allow the mere act of carrying forward an NOL to a subsequent tax year prior to taking a carryback to constitute a de facto “election” to forego an NOL carryback, a taxpayer could effectively make this election at any time prior to the due date, including extensions for the subsequent year simply by applying the previous year’s NOL on the subsequent year’s return. See Taxpayer Brief p. 6. Allowing a taxpayer to make an NOL carryforward election in this manner would clearly negate the clear intent of section 207 to confine this election to the period in which the return for the loss year can be timely filed. Accordingly, for the above enumerated reasons, I find that the taxpayer’s carryforward of its FYE 3/31/96 NOL to offset income on its timely filed return for FYE 3/31/97 did not constitute an irrevocable election to forego an NOL carryback pursuant to section 207 of the IITA for the tax and fiscal year ended 3/31/96.

However, a finding that the taxpayer failed to make an irrevocable election to forego a carryback does not necessarily mean that the taxpayer is entitled to the relief sought in its claim for refund. Such relief is contingent upon a finding that the taxpayer complied with the requirements set forth in section 207 of the IITA noted above. For the reasons enumerated below, I find that these requirements were not complied with.

As noted earlier, section 207 of the IITA provides that “for any taxable year ending prior to December 31, 1999, (a net operating loss) shall be allowed as a carryover or carryback deduction in the manner allowed under Section 172 of the Internal Revenue Code.” See 35 **ILCS** 5/207(a)(1). As also noted earlier, in the absence of an election to forego the carryback, which the taxpayer claims it never made, section 172 as in effect for the tax year in controversy, provides that “[T]he entire amount of the net operating loss for any taxable year ... shall be carried to the earliest of the taxable years to which (by reason of paragraph (1)) such loss may be carried.” See 26 **U.S.C.A.** sec. 172(b)(1)(A), (b)(2).

As is evident from the foregoing, in the absence of an election to forego an NOL carryback, federal law requires that an NOL first be carried back to the earliest year falling within the prescribed carryback/ carryforward period in which the taxpayer has income before being applied to any subsequent years. Moreover, as noted earlier, in the absence of an election to forego an NOL carryback, if the taxpayer has income in any of the carryback years, section 172 does not provide for any carryforward until all income for each such year in the carryback period has been completely offset.

In the instant case, the taxpayer incurred an NOL during FYE 3/31/96. It subsequently carried this loss forward on its timely filed FYE 3/31/97 return. The

taxpayer claims that it did not make an irrevocable election to forego a carryback, and pursuant to the taxpayer's IL-1120-X claim for refund, the taxpayer now seeks to carryback the portion of the 1996 NOL not previously applied to offset its FYE 3/31/97 income to FYE 3/31/94. See Stip. No. 7.

For the tax year at issue, IRC section 172 provides for a 3-year carryback and a 15-year carryforward of net operating loss. The returns in the record show that the taxpayer reported net income on its returns for 1993, 1994 and 1995. Pursuant to IRC section 172 as in effect during the tax year in controversy, in the absence of an election to forego an NOL carryback, the taxpayer was required to first apply the 1996 NOL to offset income shown on the taxpayer's FYE 3/31/93 return before applying any remaining portion of the 1996 NOL to any subsequent fiscal years. Contrary to the requirements of IRC section 172, the taxpayer's amended return seeks a refund for FYE 3/31/94, based upon a carryback of loss remaining after first carrying forward an NOL to offset FYE 3/31/97 income. However, since the taxpayer never made an irrevocable election to forego an NOL carryback, its carryforward of NOL to FYE 3/31/97, without first carrying the NOL back was improper. Accordingly, the taxpayer's refund claim, on its face, does not comport with the requirements of IRC section 172 as in effect for the tax year in controversy, because the taxpayer did not first carryback its FYE 3/31/96 NOL in the manner required by IRC section 172 before carrying forward the portion of the NOL remaining after first applying it to offset income in each of the 3 years preceding the fiscal year of the loss, FYE 3/31/96.

In the absence of an election to forego a net operating loss carryback, the correct manner in which the NOL for FYE 3/31/96 must be carried requires an initial application

of the FYE 3/31/96 NOL to offset FYE 3/31/93 net income, followed by a carryback to fiscal years ending in 1994 and 1995 sequentially, of any amount of NOL remaining after use of the NOL to offset the income shown on the taxpayer's FYE 3/31/93 return. Moreover, only after the taxpayer's FYE 3/31/96 loss has been applied to offset net income for each of these years can any remaining portion of the FYE 3/31/96 NOL be carried forward to FYE 3/31/97 and subsequent years. See 26 U.S.C.A. section 172(b)(2).

The only way the taxpayer could have properly carried forward the FYE 3/31/96 NOL without first carrying it back would have been by making an irrevocable election to forego any NOL carryback as permitted by Illinois and federal law. However, the taxpayer claims it did not make an irrevocable election to forego an NOL carryback and, for the reasons cited above, I concur with the taxpayer. But the consequence of the taxpayer's failure to forego an NOL carryback was that the taxpayer could not carryforward its FYE 3/31/96 NOL to FYE 3/31/97 without first carrying the loss back, beginning with the earliest of the 3 years preceding the year of loss in which it had income, which was FYE 3/31/93. Since section 207 of the IITA requires that an NOL be carried back and forward as prescribed in IRC section 172, there is no statutory authority for the carryback and carryforward reported by the taxpayer on its amended return/refund claim for FYE 3/31/94. In short, the taxpayer cannot carryforward its FYE 3/31/96 NOL to FYE 3/31/97 without making an irrevocable election to forego any carryback. However, if the taxpayer has made an irrevocable election, it cannot carryback any portion of its FYE 3/31/96 NOL to FYE 3/31/94 or any other year preceding FYE 3/31/96, the year of the loss.

In sum, for the reasons enumerated above, I find that the taxpayer did not make an irrevocable election to forego an NOL carryback, and that, because it did not do so, it was required to carryback the entire NOL to income years preceding the year of loss, beginning with FYE 3/31/93, before applying any portion of the NOL remaining after this carryback as a carryforward to offset its income in FYE 3/31/97. The taxpayer, in its amended return, seeks to initially carry its loss forward, and then carryback the remaining portion of the loss, after giving effect to the carryforward, to offset its net income for FYE 3/31/94. However, the taxpayer did not make an irrevocable election to forego an NOL carryback. Consequently, it could not carry its FYE 3/31/96 NOL forward without first carrying it back to offset its income for the 3 years preceding the loss year, beginning with FYE 3/31/93, as required by section 172(b)(2) of the IRC. Accordingly, the amended return NOL carryback procedures indicated in the taxpayer's amended return for FYE 3/31/94 to arrive at a refund due for FYE 3/31/94, did not comply with the requirements mandated by section 207 of the IITA, which incorporates by reference the procedures mandated by Internal Revenue Code section 172. For the foregoing reasons, there is no legal basis for taking an NOL carryback in the manner indicated in the taxpayer's FYE 3/31/94 amended return and its claim for refund, therefore, must be denied.

The second issue presented by the taxpayer's protest and enumerated in the pre-trial order in this case is as follows:

That the second issue is whether the filing of the FYE amended return for 1994 within the amnesty period qualified the taxpayer to avoid the application of penalty and interest in the event of a negative finding against the taxpayer in issue number one above.

The record shows that the taxpayer filed an IL-1120-X reporting federal changes for 1994 on November 13, 2003. Department Ex. 4. Accordingly, the return was filed within the amnesty period prescribed by P.A. 93-26 effective 6/20/2003. (See footnote 2). The Department audited the taxpayer's IL-1120-X, and the Department's auditor found that it showed an amount due (excluding interest and penalties) of \$13,771 for 1994 prior to the application of any NOL, as a result of federal changes. *Id.* The NOL carryback claimed by the taxpayer completely offset the amount shown to be due as a result of the federal changes and resulted in a refund due the taxpayer for FYE 3/31/94 in the amount of \$1,405. Stip. No. 7. If the Department's auditor had accepted the taxpayer's claim that an NOL was properly applicable to offset the additional amount due as a result of federal changes, the liability shown on the amended return for FYE 3/31/94 as a result of the federal changes the taxpayer reported, would have been satisfied. However, the auditor did not accept this claim and, for reasons previously enumerated, I find that the auditor's refusal to allow the NOL taken on the taxpayer's amended return for 1994 was proper.

35 ILCS 735/3-2, as amended by the "Tax Delinquency Amnesty Act ("Amnesty Act"), P.A. 93-26 effective 6/20/2003, provides as follows:

(f) If a taxpayer has a tax liability that is eligible for amnesty under the Tax Delinquency Amnesty Act and the taxpayer fails to satisfy the tax liability during the amnesty period provided for in the Act, then the interest charged by the Department under this Section shall be imposed at a rate that is 200% of the rate that would otherwise be imposed under this section.

Moreover, 35 ILCS 735/3-3, as amended by the Amnesty Act provides as follows:

(i) If a taxpayer has a tax liability that is eligible for amnesty under the Tax Delinquency Amnesty Act and the taxpayer fails to satisfy the tax liability during the amnesty period provided for in the Act, then the penalty imposed by the Department under this Section shall be imposed

in an amount that is 200% of the amount that would otherwise be imposed under this section.

The record shows that the Department's auditor in this case did not agree that the taxpayer's NOL for FYE 3/31/96 could be applied to offset its liability for FYE 3/31/94. In the absence of the application of the 1996 NOL in this manner, there was no payment or credit available to offset the taxpayer's FYE 3/31/94 liability determined as a result of the federal changes in 2003, and this liability remained unsatisfied. The Uniform Penalty and Interest Act, 35 **ILCS** 735/3-1 *et seq.*, as cited above, provides that a taxpayer's failure to take advantage of tax amnesty by fully satisfying a past liability due for a tax period eligible for tax amnesty relief during the amnesty period will result in a doubling of interest and penalties due on the unsatisfied liability amount. Since the taxpayer's NOL carryback to FYE 3/31/94 was not allowed, and no tax payment was made to cover the additional tax due as a result of federal changes for FYE 3/31/94, this liability was never satisfied. Given the taxpayer's failure to pay or otherwise satisfy the amount shown to be due on its FYE 3/31/94 return as a result of the 2003 federal change, and my finding that the taxpayer could not properly apply any portion of its FYE 3/31/96 NOL to offset this liability, the auditor's doubling of interest and penalty was expressly authorized by 35 **ILCS** 735/3-2(f) and 35 **ILCS** 735/3-3(i), and was completely proper.

During the hearing in this matter, the taxpayer attempted to argue that any penalties determined to be due on its FYE 3/31/94 amended return should be excused due to "reasonable cause" pursuant section 3-8 of the Uniform Penalty and Interest Act, 35 **ILCS** 735/3-8. However, neither the taxpayer's protest in this case, or the pre-trial order

entered in this matter raises this issue. 86 Ill. Admin. Code, ch. I, section 200.120(c) provides as follows:

(c) Protests, upon notice to the Department's representative and by leave of the presiding Administrative Law Judge, may be amended to include additional grounds not previously cited at any time prior to the entry of a final pre-trial order which designates the issues to be considered at the hearing.

The pre-trial order in this case does not note that the taxpayer has raised the issue of "reasonable cause", and there is no order entered by any administrative law judge granting the taxpayer leave to amend its protest so as to raise this issue. Since the taxpayer did not amend its protest at any time prior to the entry of a pre-trial order in this case to raise this issue of "reasonable cause", and this issue was not raised in the taxpayer's protest as originally filed, I find that the issue of "reasonable cause" has not been protested and, therefore, that this tribunal has no jurisdiction to consider this issue. See 35 ILCS 5/910. For the foregoing reasons, I have not addressed the issue of "reasonable cause" in this recommendation.

WHEREFORE, for the reasons stated above, it is my recommendation that the Department's denial of the taxpayer's claim for refund for FYE 3/31/94, including the imposition of penalties and interest pursuant to the Amnesty Act on the unpaid liability for FYE 3/31/94 as a result of federal changes, be upheld.

Ted Sherrod
Administrative Law Judge

Date: May 4, 2006